In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 71-1022

UNITED STATES OF AMERICA, PETITIONER

v.

JAMES A. BASYE AND EVELYN E. BASYE, ET AL.

WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

1. Respondents persist in arguing a case that is not before the Court. They devote the first part of their argument (Br. 13-26) to demonstrating that contingent beneficiaries of the trust should not, as such, be taxable on payments from the trust that they may not receive. As we pointed out in our principal brief (p. 7), the Government "has not sought, and does not rely, to support its assessments against the partners [on the ground] they were contingent beneficiaries." In the notices of deficiencies (R. 13-19, 24-30), deficiencies were asserted against partners in Medical Group because partnership income was increased by amounts which were compensation for partnership services although paid to the trust. Since this was additional partnership income, the partners were liable for tax on their distributive shares of the increased partnership income. (R. 18, 19, 29, 30.)

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If the partnership had deflected its compensation to persons other than partners, or to a trust for persons other than partners, that compensation would still have constituted partnership income. *Lucas* v. *Earl*, 281 U.S. 111; *Hogle* v. *Commissioner*, 132 F. 2d 66 (C.A. 10); *Effler* v. *Commissioner*, 29 B.T.A. 784. The fact that the partners were, in large part, contingent beneficiaries of the trust to which compensation was deflected can hardly reduce or defer the partnership income resulting from the payment of that compensation. Cf. *Magibow* v. *Commissioner*, 218 F. 2d 687 (C.A. 3). There was nothing contingent or uncertain about Health Plan's payments of compensation for Medical Group's services. Over $2,000,000 was paid in cash to the trust during the years 1960–1963. As respondents acknowledge (Br. 4), none of this amount was to be, or ever was, repayable to Health Plan.

2. Respondents would turn exactly in reverse the tax treatment of partnership income provided by every revenue act since 1913 when they state (Br. 31) that partnership income consists only of the aggregate of partners' income, computed without reference to the partnership.[1] Sections 701–704 of the Internal Revenue Code of 1954 require, as every preceding income tax statute has required, that partnership income be first computed (Sec. 703), and that each partner take into income his distributive, or proportionate, share thereof. (Secs. 702 and 704.) No substantive change was made by dropping the phrase "whether or not distribution is made to him," which appeared in Section

[1] Since the partnership pays no tax, there would be no reason to compute partnership income if respondents were correct.

182 of the Internal Revenue Code of 1939.' 6 Mertens, *Law of Federal Income Taxation* (Rev.), Sec. 35.29. Perhaps the most explicit illustration of the relationship between a partner's taxable income and partnership taxable income is the fact that a cash basis partner must nevertheless take into his income his distributive share of accrued partnership income if the partnership has elected the accrual method of accounting. 6 Mertens, *supra*, Sec. 35.61.

Respondents seek to find support in this Court's decision in *Neuberger* v. *Commissioner*, 311 U.S. 83; but that decision has little relevance to this case. It dealt only with the question whether the character of an item of partnership income (income from the sale of securities) was reflected in the partners' shares of distributive income, one of the questions of characterization of income now dealt with in detail by Section 702 and the regulations thereunder. Here we have no question of characterization of income, or of any special treatment afforded by the Code to income of a certain character. Compensation for services, the income here involved, is ordinary income to a partnership, and ordinary income to a partner. It falls within the residuary or catchall provision of Section 702(a)(9). To the extent that the *Neuberger* decision has relevance here, it supports our position in that its very point of departure is that each partner must take into his income his proportionate share of part-

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* "Under your committee's bill, as under existing law, partners will be liable individually for income tax on their distributive shares of partnership income." H. Rep. No. 1337, 83d Cong., 2d Sess., p. 65. See also S. Rep. No. 1622, 83d Cong., 2d Sess., p. 89.

nership income. That is true whether distribution is made, is not made, or can not be made. *Heiner v. Mellon*, 304 U.S. 271.

3. As we have pointed out, this case rests upon two decisions of this Court, each fundamental in the field of income taxation. First, compensation for services constitutes taxable income and must be taxed to him who earns it; the tax cannot be avoided by anticipatory arrangements and contracts however skillfully devised. *Lucas v. Earl*, 281 U.S. 111. The payments of compensation for Medical Group's services were therefore taxable income to the Medical Group partnership, even though deflected to a trust, just as they would have been taxable to the partnership if they had been deflected to the partners' wives, or any one else. Second, partners must take into income their distributive, or proportionate, shares of partnership income, whether or not that income is or can be distributed. *Heiner v. Mellon*, 304 U.S. 271. The respondents were therefore required to take into their income their proportionate shares of Medical Group's taxable income because they were partners, not because of any relationship they may or may not have had to the trust to which Medical Group's compensation was deflected. Cf. *Griffiths v. Commissioner*, 308 U.S. 355, 357.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

DECEMBER 1972.

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